In the Supreme Court of the United States

OCTOBER TERM, 1943.

No. . . . .

CLAIRE A. PEKRAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

No. . . . .

JOHN PEKRAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF PETITIONERS IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI.

In support of the joint Petition for Writs of Certiorari, we submit this brief setting out our reasons for believing these three leases sold by these petitioners on May 1, 1940, were capital assets within the meaning of Section 117(a) (1), Internal Revenue Code.

SUMMARY DISCUSSION OF FACTS.

I. AS TO CLAIRE A. PEKRAS CASE.

She acquired this lease of land, title to the Capitol Theatre buildings thereon subject to reversionary rights of the lessor, and full ownership of the theatre equipment, for a lump sum in 1934. (C. A. P. Rec. pp. 15, 18.)

In 1934 there was no reason, tax-wise or otherwise, for making any allocation of costs to the separate items covered by her purchase contract. Actually the lease cost her nothing. It was to be modified as to rentals and extended as to term. (C. A. P. Rec. p. 22.) At the rental, before modification, the lease was recognized by buyer and seller as a liability to be assumed rather than an asset to be purchased. Accordingly she set up on her records her entire payment as cost of buildings and equipment. (C. A. P., Rec. pp. 19, 20.)

On her income tax returns for years 1935 through 1939, she claimed, and Respondent allowed, a deduction in lieu of depreciation, under Regulations 103, Sec. 19.23(a)-10, based on that cost of buildings and equipment. (C. A. P. Rec. p. 24.)

She sold the buildings and equipment at a profit. No question is involved here as to that. At the same time she specifically sold the lease for $105,000. (C. A. P. Rec. p. 25.)

II. AS TO JOHN PEKRAS CASE.

In 1937 he acquired the New Rivoli lease, for the term of twenty-five years starting January 1, 1941. (C. A. P. Rec. pp. 16, 25.) He paid nothing to the lessors therefor. (C. A. P. Rec. p. 21.) To protect his title under that lease he did, thereafter, pay $4,500 to acquire outstanding adverse interests. That sum he capitalized, but claimed no recovery thereof as an income tax deduction since the term of that lease did not begin until eight (8) months after he sold it. (C. A. P. Rec. pp. 21, 25.)

In 1932 he acquired the Lincoln lease for the term of twenty-five years starting Jan. 1, 1933. He paid nothing for it. (C. A. P. Rec. p. 25.)

Thus he acquired both leases prior to the beginning of their terms. He paid nothing to either lessor therefor. Yet after expressly finding those stipulated facts, the Tax Court, in the final paragraph of its Opinion, makes this amazing statement:

> "The leaseholds that petitioners sold were acquired by purchase during their fixed terms." (C. A. P. Rec. p. 26.)

III. AS TO BOTH CASES.

Payments by the purchaser were spread over a ten year period. From the payments received in 1940 and 1941 petitioners reported their gains from sales of buildings and equipment as ordinary income. Their gains from sales of these leases were reported as long-term gains from sales of capital assets, 50% taxable.

Respondent assessed the deficiencies on his contention that these leases were not capital assets and that the gains from sales thereof were ordinary income, 100% taxable.

The case of Claire A. Pekras involves a claimed income tax deficiency of the year 1940 of $3,469.32. (C. A. P. Rec. p. 11) and, by mutual understanding, also determines liability as to a similar claimed deficiency for 1941 of $6,424.90.

The case of John Pekras involves a claimed income tax deficiency for the year 1940 of $4,158.06 (J. P. Rec. p. 10) and, by mutual understanding, also determines liability as to a similar claimed deficiency for 1941 of $7,198.76.

ERRORS ASSIGNED.

There is error manifest on the face of the Records in these cases in this, to-wit:

I. Said Tax Court and said Circuit Court of Appeals erred in construing the language of Sec. 117(a)(1), Internal Revenue Code, which reads:

"property * * * of a character which is subject to the allowance for depreciation provided in section 23 (l) * * *,"

as if that language was, instead:

property * * * of a character which under other circumstances might be subject to any allowance for, in lieu of, or in the nature of, depreciation under any section of the Internal Revenue Code.

II. The said Courts erred in sustaining a contention of Respondent directly contrary to his Regulations issued for guidance of taxpayers and effective for over twenty years, thereby approving a policy of deliberate taxpayer entrapment.

III. Said Circuit Court of Appeals erred in adopting as binding upon it a conclusion of fact stated by the Tax Court, directly contrary to facts stipulated by the parties and expressly found by the Tax Court earlier in its Opinion.

IV. Said Circuit Court of Appeals erred in affirming the decision of the Tax Court and in denying our Petition for Rehearing.

REASONS FOR ALLOWANCE OF THE WRITS.

I. So far as we can learn, the question of the proper interpretation of this portion of Section 117(a)(1), Internal Revenue Code, has never been presented to or decided by this Honorable Court. Affecting as it does all intangible property used in business, it is a question of great general interest to taxpayers and tax collecting authorities. We feel that it is of sufficient importance to merit consideration and final determination by this Honorable Court.

II. The said Circuit Court of Appeals, in affirming the Tax Court, decided this question of federal law in a way probably in conflict with applicable decisions of this Honorable Court for reasons pointed out in our Argument herein.

III. Does not a construction of this statute by Respondent which is directly contrary to his long standing Regulations issued for guidance of, and relied upon by, taxpayers, constitute taxpayer entrapment which should be judicially disapproved?

IV. Shall conclusions of fact, found by any trier of facts, be conclusive on reviewing courts when obviously untrue and contrary to all the evidence?

We cannot but believe that the decision of this Honorable Court in *Dobson vs. Commissioner of Internal Revenue*, Nos. 44 and 47, decided Dec. 20, 1943, reported in Vol. 88 (Advance Sheets), Law Ed. p. 179, impelled the Circuit Court of Appeals to deny our Petition for Rehearing and thereby refuse to consider the obvious error of the Tax Court pointed out therein. (C. A. P. Rec. p. 45; J. P. Rec. p. 29.)

We do not believe this Honorable Court intended to, or did, announce such rule in said *Dobson* case. We do believe that this Circuit Court of Appeals acted on the assumption that Your Honors had announced that rule. We believe these cases present the logical opportunity to define the intended limits of the *Dobson* case rule.

SUMMARY OF ARGUMENT.

As to the questions presented and errors assigned our contentions are:

I. These leaseholds are not within the definition of non capital assets given in Section 117(a)(1), Internal Revenue Code, because:

A. The statute should be construed so as to give effect to the words "*is* subject" and "*the* allowance" used therein.

B. A leasehold as it relates to land, distinguished from tangible property on that land, is not subject to "the allowance for depreciation provided in section 23(l)," since:

1. Such allocation between land and tangible physical property on that land is proper.

2. Such interest in land is not depreciable, in any sense of that term, in the absence of present loss of capital investment therein.

II. Respondent having by Regulations provided that any such allowance to a lessee is under Section 23(a), Internal Revenue Code, should not now be permitted to claim it is under Section 23(l). Such reversal of position constitutes deliberate taxpayer entrapment.

III. A conclusion of the Tax Court, contrary to facts stipulated and found, is not binding upon and should not be adopted and followed by reviewing courts.

ARGUMENT.

I. THESE LEASEHOLDS ARE NOT WITHIN THE DEFINITION OF NON CAPITAL ASSETS GIVEN IN SEC. 117(a)(1), INTERNAL REVENUE CODE, BECAUSE:

A. The statute should be construed so as to give effect to the words "is subject" and "the allowance" used therein.

The statute reads:

> "The term 'capital assets' * * * does not include * * * property * * * of a character which is subject to the allowance for depreciation provided in section 23(l) * * *."

The ruling of the Tax Court, affirmed by the Circuit Court of Appeals, amounts to just this:

That any leasehold, regardless of whether or not there was any capital investment in it, regardless of the term of the lease, is property subject to the statutory allowance (Sec. 23(l), Internal Revenue Code) for depreciation.

That ruling interprets the statute as if it read:

> Property * * * of a character which *might be*, under other circumstances or at a later date, *subject* to *any allowance in the nature of* depreciation.

We believe the statute should be construed so as to give effect to the words "*is* subject" and "*the* allowance."

> "It is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word."
>
> *Market Co. v. Hoffman*, 101 U. S. 112 at 115.

The courts below ignored that rule.

We believe the statute in defining "character" of the property sets up two essential elements; (1) that it be currently subject to an allowance, and (2) that it be subject to the specific statutory allowance. The leases sold by petitioners lacked both of these elements.

B. A leasehold, as it relates to land, distinguished from tangible property on that land, is not subject to "the allowance for depreciation provided in section 23(l)," since:

1. Such allocation between land and tangible physical property on that land is proper.

Congress recognized that this exclusion of certain property from "capital assets" did not apply to land.

> "For example, if an apartment house is sold, under the present law, it is necessary to separate the land from the building for income tax purposes."
>
> Committee Report on the Revenue Bill of 1942;
> House of Representatives Report No. 2333;
> Int. Rev. Cum. Bull. 1942-2, p. 414, par. 21.

Respondent expressly stated that it had no application "to the extent that such gain or loss is allocable to the land, as distinguished from depreciable improvements on the land." Regulations 103, Sec. 19.117-1.

Congress recognized the necessity for, and Respondent required, such allocation. On these sales both petitioners and the purchaser made such allocation. (C. A. P. Rec. p. 25.) Now Respondent seeks to deny effect thereto.

The petitioners and the purchaser definitely fixed \$105,000, \$60,000 and \$49,000 as the price for the respective leases, in addition to the prices fixed for buildings and equipment. Such prices were not extra payments for the tangible physical property. Rather they were definite allocations, by both buyer and seller, of a specific value to these interests in land, to the right to use these lands as sites for these theatres for a definite term of years.

The rulings of the courts below refuse effect to the allocations so made and thereby defeat Congressional intent and nullify the Treasury Regulations.

And that in face of the fact that these leases are interests in land.

In Ohio a lease constitutes "a sale of an interest in real estate."

Brenner, et al. v. Spiegle, 116 Ohio State 631.

An Ohio land trust certificate is an interest in land and taxes imposed thereon are taxes on land.

Senior v. Braden, et al., 295 U. S. 422.

Since a tax on an interest in land is a tax on land, how can it be held that a profit from sale of an interest in land is not profit from a sale of land?

Yet the courts below have held the profit from these sales of these interests in land to be profit from the sale of property subject to the statutory allowance for depreciation.

2. Such interest in land is not depreciable, in any sense of that term, in the absence of present loss of capital invested therein.

The only possible reason for the statute removing depreciable property from the "capital asset" classification, is that through the depreciation allowance the owner has recovered part of his capital investment. His base for determining profit or loss in event of sale has changed. If there has been no capital investment, or no part of any

investment has been recovered or is legally recoverable, there is no reason or excuse for the distinction. Yet taxation is supposed to be a practical matter. *Harrison v. Schaffner*, 312 U. S. 579 at 582.

In *Weiss v. Wiener*, 279 U. S. 333, where this same Circuit Court of Appeals was once before in error as to depreciation, Mr. Justice Holmes, referring to a lessee, said:

> "Of course, he must show an interest in the property and a present loss to him to make the statute apply." p. 336.

If the statute does not "apply," how can the property be currently subject to it?

The history of the case relied on by the Respondent and the Tax Court, when compared with these cases, is illuminating.

Eighteen months after these petitioners sold these leases the Board of Tax Appeals, on Nov. 14, 1941, decided *Fackler v. Commissioner*, 45 B. T. A. No. 115. It held the Fackler lease was not a capital asset. That was the first time this question had been judicially determined. Thereupon Respondent first raised the issue as to petitioners. This same Circuit Court of Appeals affirmed the Board. *Fackler v. Commissioner*, 133 Fed. (2d) 509.

That case is clearly distinguishable from these cases.

There Fackler had established a cost for his leasehold interest in land and buildings as a unit. He had claimed depreciation. Here petitioners had no investment in their interests in lands recoverable in any part while they owned such interests. There Fackler made no allocation on the sale of any part of the selling price to the interest in land apart from the interest in buildings. Here such specific allocation was made. There no question as to interpretation of the statute was raised, no issue as to the Regulations was presented. Here such question and issue, duly raised, were ignored.

When our case came before the Tax Court they brushed aside all issues distinguishing features of our cases, saying:

> "Generally speaking, a leasehold is of such character" (i.e. subject to depreciation), "(*Fackler v. Commissioner*, 133 Fed. (2d) 509), * * *." (C. A. P. Rec. p. 26.)

The Circuit Court of Appeals in its *Fackler* opinion, 133 Fed. (2d) 509, relied on *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252. And remarks by Judge Allen during argument of these cases clearly indicated that she, at least, was still relying on that case as holding all leaseholds to be depreciable property.

But in *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252, this Honorable Court did not so decide. This Court did not even intimate that every leasehold, or even that "generally speaking" a leasehold, is depreciable property. Rather this Honorable Court sustained the lower courts in treating a nominal leasehold as an actual fee. There the taxpayer had ostensibly sold the property to a trustee; the trustee had sold land trust certificates and given back to taxpayer a lease. If it was a lease, then lessee had no capital invested in it. But Your Honors held that in reality the transaction was a pledge of the property as security for a loan. Accordingly Lazarus & Co. was, in truth, the owner with a capital investment in lands and buildings as to which it was sustaining a current loss, allowable as an income tax deduction.

Far from holding that every leasehold is depreciable property, as the Tax Court and the Circuit Court of Appeals imply, this Honorable Court there clearly recognized the rule, here contended for by petitioners, that a leasehold in which a lessee has no capital investment as to which a current loss is sustained is not depreciable property.

Weiss v. Wiener, supra, and *Helvering v. F. & R. Lazarus & Co., supra,* establish that for income tax purposes all leaseholds may be divided into two classes:

One. Those of a character subject to the statutory allowance for depreciation, or a rental expense allowance in lieu thereof. The essential element of that character being a capital investment by lessee as to which a present loss is sustained.

Two. Those of a character not subject to any such allowance. The essential element of that character being no present loss of capital investment.

The courts below ignored that distinction.

II. RESPONDENT HAVING BY LONG CONTINUED REGULATIONS PROVIDED THAT THE ONLY ALLOWANCE TO LESSEES IN LIEU OF, OR IN THE NATURE OF, DEPRECIATION IS UNDER SECTION 23(a), INTERNAL REVENUE CODE, SHOULD NOT NOW BE PERMITTED TO CLAIM IT IS UNDER SECTION 23(l).

Such reversal of position, without change of Regulations, constitutes deliberate taxpayer entrapment.

This Honorable Court has said:

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes are deemed to have received congressional approval and have the effect of law."
>
> *Helvering v. Winmill,* 305 U. S. 79 at 83.

Treasury Regulations No. 103 were in effect when these petitioners made these sales. As taxpayers they were told how to use them.

> Reg. 103. *Explanation of Regulations.* * * * "By use of these key numbers one can readily ascertain how a given section, subsection, or paragraph of the Internal Revenue Code has been interpreted by the Bureau. Thus, one desiring to learn what interpreta-

tion has been placed on section 23(d) of the Code should turn to section 19.23(d)-1 of the regulations. * * *''

Pursuant to such instructions we turn to Section 19.23(l) to find how Section 23(l) of the Code has been interpreted. We find therein not one word relating to deduction of depreciation by a lessee.

But under Section 19.23(a)-10 we find:

> "Sec. 19.23(a)-10. *Rentals.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. * * * The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of the lease, and such deduction shall be *in lieu of* a deduction for depreciation. * * *'' (Emphasis ours.)

Similar provisions have appeared in each issue of the Regulations since Reg. 62 issued in 1921, and appear without change in Reg. 111, Sec. 29.23(a)-10, issued Oct. 26, 1943, while these cases were pending in the Circuit Court. They have stood without material change as the announced policy of Respondent for twenty-three years.

They must have embodied the interpretation Congress intended in specifying this particular Section 23(l) in the revision of Sec. 117(a)(1).

Throughout the years since 1921 Respondent has, by these Regulations, denied to lessees the allowance under Section 23(l). Throughout those years Respondent has, by those Regulations, granted lessees a rental expense deduction "in lieu of" that statutory allowance, under a different section, namely, Section 23(a).

Now when these petitioners have relied and acted on those Regulations the Respondent seeks to change his interpretation. Is there no obligation of consistency on him? *Virginian Hotel Corp. v. Helvering*, 319 U. S. 523, dissent of Mr. Justice Jackson, pp. 531-532. Yet even while Respondent seeks to enforce this new interpretation, he reissues the original interpretation in Regulations No. 111.

If that is not deliberate taxpayer entrapment we know not what to call it.

Under what theory of statutory construction can an allowance "in lieu of" a specified allowance be held to be "the" specified allowance itself? The lower courts have refused to answer that question. We submit it merits an answer.

III. A CONCLUSION OF THE TAX COURT, CONTRARY TO FACTS STIPULATED AND FOUND, IS NOT BINDING UPON AND SHOULD NOT BE ADOPTED AND FOLLOWED BY REVIEWING COURTS.

As pointed out in the foregoing discussion of facts as to the John Pekras case, the parties stipulated and the Tax Court found in the early portion of its Opinion:

That John Pekras paid nothing for either lease when he acquired them. He acquired both prior to the beginning of their respective terms. Yet the Tax Court concludes:

> "The leaseholds that petitioners sold were acquired by purchase during their fixed terms." (C. A. P. Rec. p. 26.)

That statement is partially true as to the Capitol lease sold by Claire A. Pekras. But as to the two leases sold by John Pekras it is absolutely untrue.

If the matters of statutory construction and the effect of the Regulations be ignored that conclusion does support the decision in the Claire A. Pekras case. The evidence being not conclusive the Tax Court's finding should be binding.

But as to the John Pekras case, the undisputed fact is that he had no recoverable capital investment in either lease he sold. The decision in his case can be supported only if this false conclusion be taken as not subject to review. The obvious falsity of that conclusion distinguishes the John Pekras case from the Claire A. Pekras case. The lower courts ignored that distinction.

CONCLUSION.

We therefore believe these cases merit the exercise by this Honorable Court of its supervisory authority so that the errors complained of may be corrected. We believe that, accordingly, the writs of certiorari should be granted, the issues reviewed and determined and the decisions of the Circuit Court of Appeals reversed.

Respectfully submitted,

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Counsel for Petitioners.